

General Information Letter: General discussion of tax treatment of a limited liability company that has elected to be treated as a partnership for federal income tax purposes.

May 9, 2001

Dear:

This is in response to your letter of March 26, 2001 in which you request a private letter ruling. Department rules require that the Department issue two types of rulings, private letter rulings and general information letters. The Department has adopted rules concerning letter rulings and other information issued by the Department (2 Ill. Adm. Code 1200). These rules can be obtained from the Department's website, which can be accessed at [www.revenue.state.il.us](http://www.revenue.state.il.us). We would be happy to send you a copy of those rules at your request.

Although you have not requested either type of ruling on behalf of your company, the nature of your questions and the information you provided necessitates that we respond in the form of general information letter. A general information letter, which is designed to provide general information, is not a ruling that is binding on the Department.

In your letter you wrote:

I am writing on behalf of my client to request guidance, regarding the potential requirement to file corporate income and/or franchise tax returns in your state. My client is primarily involved in the business of mortgage banking. Although this corporation currently services loans in your state and may eventually hold a security interest in real property if foreclosure occurs, they have no offices, employees, or other representatives located in your state. The corporation is, however, registered to do business in the your state, and obviously wishes to have rights in the court of the state with respect to foreclosure.

As stated above, our client's primary business activity is that of a "mortgage banker". *The 5<sup>th</sup> Edition of Black's Law Dictionary* defines mortgage banker, as:

[a] person or firm engaged in the business of dealing in mortgages including their placement and refinancing. Normally such banker uses its own funds as opposed to a commercial or savings and loan bank, which uses primarily funds of depositors. While some mortgage bankers do provide long-term (permanent) financing, the majority specialize in short-term and interim financing. Mortgage bankers, or mortgage companies, are in the business of originating mortgage loans to sell. Attendant to the mortgage loan origination and resale functions, mortgage bankers may service loans, write hazard insurance, broker loans or property, manage property, act as leasing agents, or act as appraisers.

As background, some states, like California, would classify our client, based on its activities, e.g., a company engaged in the business of soliciting loans secured by first deeds with the intention of assigning them to institutional investors is considered to be dealing in moneyed capital in competition with national banks and, therefore, for California franchise/income tax purposes is treated as a financial corporation. Other states, like Illinois, look to the specific categories of entities listed in the statutory definition of "financial organization" in the Illinois Income Tax Act. Mortgage banking corporations do not qualify as financial organizations for Illinois income tax purposes.

Our client's more specific facts are, as follows:

- Our client is a mortgage banker, organized as a Limited Liability Company (LLC), taxed as a partnership, with its headquarters in Indiana, that began operations in your state in the year 2000;
- Our client is registered to do business in each of the states in which it originates loans;
- From its Indiana office it solicits loan originations in Illinois, Indiana, Kentucky, Michigan, Ohio, Oklahoma and Tennessee;
- Our client has an Arizona office that solicits and originates loans in Arizona, California and Utah;
- The personnel in the Arizona office also work with two wholesale loan originators, who work out of home offices in California, one wholesale loan originator in Arizona and one wholesale loan originator in Utah, who also both work out of a home offices;
- Loan originations are solicited through advertisements in national publications, by making telephone calls to potential customers, by purchasing leads from telemarketing companies, and through referrals from affinity relationships with various banks, finance and insurance companies;
- Our client does not currently advertise in local or so-called "national" yellow pages, but is currently considering doing both types of advertising;
- Loans that are originated by our client are funded on their behalf by various title companies, who also prepare loan packages and perform the closings on behalf of our client; and
- Our client also purchases loans from other loan originators and resells them.

We have five questions we would like addressed, in order to clarify our client's income and/or franchise tax filing requirements in your state, as follows:

1. Based on the above description of our client's activities in your state, do these activities create nexus for income and/or franchise tax purposes in your state for either the LLC or its members? If so, please cite your statutory authority and/or other basis for that determination.
2. Based on the above description of our client's activities in your state, would your state classify and treat the LLC as a regular LLC or would it be treated as a financial institution or financial organization under your state's law? Please cite the statutory authority and/or other basis for your determination.
3. Does your state require LLC's or its members to file income and/or franchise tax returns, if the LLC does not have nexus in your state, but is registered to do business? If so, please cite your statutory authority and/or other basis for that determination.
4. If the LLC or its members are required to file income and/or franchise tax returns in your state, please provide guidance as to the specific filing requirements, e.g., which tax forms

need to filed, for both the LLC and its members. If members are required to file income tax returns, are composite returns permitted for individual members and are there nonresident withholding requirements for individual members? Please cite the statutory authority and/or other basis for your determinations.

5. If the LLC or its members are required to file income and/or franchise tax returns in your state, please provide guidance on the sourcing rules for apportionment factor purposes of:
  - a. how revenue from loan origination fees, where loans are closed in your state on behalf of our client by unrelated third-parties, is sources for the sales or receipts factor;
  - b. how interest income from loans on real property located in your state are sourced for the sales or receipts factor; and
  - c. whether loans held by our client are included in the property factor and how are they sourced.

Please cite the statutory authority and/or other basis for your determinations.

Both xxxxxxxxxxxx and our client are eager to receive you responses to our inquiries, as we need the information to accurately and timely file income and/or franchise tax returns with your state.

## **DISCUSSION**

## **ANSWERS**

The following answers are only intended as a reply to your income tax questions. The Department of Revenue does not administer the franchise tax. To determine your client's status under the franchise tax you must contact the Secretary of State.

1. In answer to your letter, it is not within the scope of a general information letter to determine whether a taxpayer has nexus with the state of Illinois. Such a determination can only be made in the context of an audit wherein the auditor would have full access to all pertinent information. Rather, a general information letter is appropriate for discussing general aspects of Illinois law. Accordingly, I can provide you with a general discussion of the law in Illinois.

Illinois law determines "doing business" as the prevailing principles of jurisprudence under the commerce and due process clauses of the US Constitution. The leading case in the area is *Quill v. North Dakota*, 112 S.Ct. 1904 (1992), which found that a state could not tax a business whose only activity within a state is by mail order. Some physical presence is necessary and a taxpayer must purposefully avail itself of an economic market before a state could exert jurisdiction over a taxpayer for taxing purposes. However, subject to the limits of *Quill* and PL 86-272 a state is allowed to tax someone if it so chooses. The providing of services does not qualify for protection under PL 86-272. But, occasional visits to the state would probably satisfy

the commerce and due process clauses. In the New York case of *Orvis v. Tax Appeals Tribunal*, 86 N.Y.2d 165, 654 N.E.2d 954 (1995), the court found that four visits to nineteen customers in one year was enough to allow the state to tax a Vermont wholesaler.

2. Your client would probably not be treated as a financial institution for Illinois income tax purposes. Because it has elected partnership treatment for federal income tax purposes, it would be treated as a partnership for Illinois income tax purposes. 35 ILCS 5/1501(a)(16).
3. Section 502(a)(2) states in part:
  - (a) In general. A return with respect to the taxes imposed by this Act shall be made by every person for any taxable year:
    - (1) For which such person is liable for a tax imposed by this Act, or
    - (2) In the case of a resident or in the case of a corporation which is qualified to do business in this State, for which such person is required to make a federal income tax return, regardless of whether such person is liable for a tax imposed by this Act.

As a partnership, your client would be required to file a return only if it has a liability.

4. Should the LLC need to file Illinois income tax returns, it would file the Form IL-1065. Composite returns may be filed for partners or shareholders. 86 IL Admin. Code 100.5100. The requisite form is IL-1023-C. If partners/shareholders do not file a composite return, they would use Schedule K-1-P to help them report their share of entity factors.
- 5.a. Illinois uses a single sales factor for determining the allocation of business income. Allocation is determined by analyzing the "cost of performance" associated with the income producing activities. Section 304(a)(2) of the Illinois Income Tax Act states in part:
  - (C) Sales, other than sales of tangible personal property, are in this State if:
    - (i) The income-producing activity is performed in this State; or
    - (ii) The income-producing activity is performed both within and without this State and a greater proportion of the income-producing activity is performed within this State than without this State, based on performance costs.

When a business has an office and employees in Illinois, cost of performance is typically located in Illinois. For more amorphous transactions one must look to where activity related to the transaction occurred. This may be where the employees who process the loan are located or where actions associated with the loan occur. The actions of unrelated third parties are not considered in the cost of performance, even if they are on behalf of your client. Therefore, revenue from such loan origination fees would not be allocated to Illinois.

- b. The interest income from loans on real property located in Illinois would similarly be located where the cost of performance occurred. While the registering of the mortgage in Illinois may

cause some performance related costs to be allocated to Illinois, they would be a small part of the total costs of performance.

c. Illinois does not use a property factor.

As mentioned above, this is merely a general information letter and not a statement of policy and is not binding upon the Department. I hope that this has been helpful to you. If you have additional questions please feel free to contact me at the above address.

Very Truly Yours,

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